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Legend

Taxpayer =

Coop =

State A =

Authority =

Plant #1 =

Plant #2 =

Dear :

This is in response to a request for rulings dated December 14, 2009, submitted by your authorized representative. The ruling request concerns whether the Taxpayer will be a corporation operating on a cooperative basis.

Coop was organized in as a rural electric cooperative under the State A Statutes, , “Electric and Telephone Cooperative Act”. In , the Internal Revenue Service determined that Coop was exempt from federal

income tax as a rural electric cooperative pursuant to the predecessor sections of sections 501(a) and 501(c)(12) of the Internal Revenue Code. Coop has filed an information return on Form 990, Return of Organization Exempt from Income Tax, with the Service for each year subsequent to its receipt of the determination letter in .

If Coop were to lose its tax exemption as a nonexempt rural electric cooperative it would be taxed under the body of federal cooperative tax law that existed prior to the enactment of subchapter T of the Code as part of the Revenue Act of 1962 (Pub. L. No. 87-834 (H.R. 10650)).

Coop now serves nearly members in rural interior State A. It operates and maintains miles of transmission and distribution lines and substations. In Coop had a peak generation load of approximately Megawatts (MW) served by a diversity of fuels including hydro-electric, turbine oil, naphtha and coal.

Coop's electric generation, transmission and distribution assets are financed by the Rural Utilities Service (RUS), the Federal Financing Bank (FFB), the National Rural Utility Cooperative Finance Corporation (CFC), and CoBank who collectively hold \$ in first mortgages as of year-end, .

Authority is the authority that, among other responsibilities, supports the development and/or expansion of electric generation, transmission and distribution within the state. The Taxpayer is a rural electric cooperative organized under the same State A Statute as Coop for the purpose of generation, transmission or distribution of electric energy. The Taxpayer was organized as a vehicle through which Authority and Coop can accomplish certain transactions.

In Coop placed into service a MW coal-fired electric generation station known as Plant #1. All financing for Coop's was provided by the RUS. Twenty years later, with Coop's acquiescence, Authority submitted an application to the U.S. Department of Energy (DOE) for Plant #1 to be a test-site for clean coal burning technology.

In , DOE selected the Authority's application to co-locate a new experimental MW electric generation plant at the Coop Plant #1 site. Plant #2 began burning coal in and generated power intermittently through in its testing phase. As the operator of Plant #2, Coop made the decision to temporarily put the facility in "warm lay" status in because of various technology flaws and the fact that it was not economical. Negotiations between Authority and Coop to resolve the various operational and management disputes were unsuccessful and in Authority filed a lawsuit against Coop alleging breach of contract.

In Coop reached a proposed settlement with Authority regarding Plant #2. In accordance with that settlement, Coop or an entity wholly-owned by Coop (i.e., the

Taxpayer) will pay Authority \$ _____ for Plant #2 in "as is" condition. Coop or the wholly-owned entity will assume all responsibility and risks associated with the ownership and operations of the plant. Authority will offer no warranty for the operational capacity of the plant and condition of the facilities.

Authority has proposed to finance the purchase price with a secured loan to Coop or a wholly-owned entity at an annual rate of interest of _____ percent, which accrue from the date of the sale. Payment of principal and interest will commence _____, or when Plant #2 first begins commercial operation, whichever is earlier, and will be amortized over _____ years with no prepayment penalties.

Authority proposes to finance an additional \$ _____ as a secured credit facility to Coop or an entity wholly-owned by Coop for plant startup and system integration costs. The annual rate of interest for those funds will be _____ percent, and will accrue from the date of each draw. Payment of principal and interest will commence _____, or when Plant #2 first begins commercial operation, whichever is earlier, and will be amortized over _____ years with no prepayment penalties.

There is a proposed operation and maintenance agreement for Plant #2 that will be entered into by and between Coop and the Taxpayer as agreed to by Authority. This agreement calls for the operation, maintenance, recordkeeping, planning and other prudent utility conduct of Coop and the Taxpayer with respect to Plant #2. It will address, among other topics fuels, other supplies required to operate and maintain Plant #2 under long-term supply agreements. In addition, the proposed document will specify the Operating Agreement term, the operator's general duties, annual operating planning and the access to facilities among the parties.

It is proposed that the Taxpayer will sell to Coop and Coop will agree to purchase from the Taxpayer, all of the electric power produced at Plant #2, subject to the term and conditions of the proposed Power Purchase Agreement (PPA). The term of the PPA is from the date that the governing bodies of Authority, Coop, and the Taxpayer agree (the Effective Date) and will end if all necessary approvals have not been obtained within one year of the Effective Date. Once all necessary approvals have been obtained, the parties may terminate the PPA during the economic life of Plant #2 only if the Authority loan obligations have been fulfilled. After that date, the Coop and the Taxpayer may terminate the PPA at any time by mutual agreement.

Within ten (10) days of the end of each month, the Taxpayer will deliver an invoice for Coop's capacity and energy consumption in the preceding month. Coop shall pay all undisputed charges in accordance with the Agreement within thirty (30) days.

Because of difficulties obtaining security lien accommodations from its existing creditors, Coop has organized the Taxpayer in which it is the sole member. The Taxpayer will take title to specified Plant #2 assets, engage in the repair and refurbishment of the generating station, take primary responsibility for all financing activities with regard to the facility and sell Plant #2 electric capacity and energy to Coop.

The Articles of Incorporation of the Taxpayer call for non-profit cooperative operation under _____, of the State A Statutes (i.e., the Electric and Telephone Cooperative Act). Article I declares the name to be Taxpayer. Article II states that the duration of the cooperative to be perpetual.

Article III states that the purpose of the organization, among other things, are to generate, manufacture, purchase, acquire, accumulate and transmit electric energy and distribute, sell, supply and dispose of such electric energy to its members, to governmental agencies and to others.

Article IV discusses the cooperative's powers. Article VIII states that the cooperative will be formed without any purpose of pecuniary profit to itself and declares it shall have no capital stock. Further, it declares that the initial membership of the cooperative shall be constituted of the charter member Coop, as represented by Coop's Board of Directors.

Article IX discusses the Taxpayer's Board of Directors. It states that the business and affairs of the Taxpayer shall be vested in, managed and controlled by a Board of Directors. Further, the number of directors of the cooperative [Taxpayer] shall not be less than seven (7) each of whom shall be a board member of Coop until such time as more members are admitted.

In Article 1, Section 1.03(A) of the Taxpayer's Bylaws, it is stated that any Member shall be a distribution electric cooperative that purchases electric capacity and/or energy, or other products and/or services from the Taxpayer. The Taxpayer's Bylaws provide for other distribution electric cooperative members and other patrons participating in the organization on a cooperative basis. However, there are no other Taxpayer members other than Coop at present.

Article 1, Section 1.03(B) states that all Members shall pay for all of the electric energy or other related products and services at such time and at such rates or prices as shall be approved by the Board of Directors. It is expressly understood that amounts paid for electric energy or for other products or services in excess of the cost of service are furnished by a Member as capital and the Member shall be credited with capital so furnished.

Article 1, Section 1.03(C) states that a unanimous vote of the Members shall be required to pursue any major new projects including but not limited to new generation, transmission or alternative retail electric suppliers.

Article 2, Section 2.01 states that a member shall have no individual or separate interest in the property or assets of the Taxpayer except, upon dissolution, after (1) all debts and liabilities of the Taxpayer shall have been paid, and (2) all capital furnished through patronage shall have been returned. Any remaining property and assets of the Taxpayer shall be distributed to its Member or Members based on the historic patronage of each.

At any Meeting of the Members, Article 3, Section 3.05 specifies that Member(s) shall be entitled to only one (1) vote upon each matter submitted to a vote.

For the Board of Directors, Article 5, Section 5.02 entitles each Member to one (1) Director. At Article 5, Section 5.06 each Director is entitled to one (1) vote.

Article 8, Section 8.01 of the Taxpayer's Bylaws state that it shall be at all times operated on a cooperative non-profit basis for the mutual benefit of its Member(s) or other patrons. No interest or dividends shall be paid or payable by the Taxpayer on any capital furnished by its Member(s) or other patrons.

Article 8, Section 8.02(A) of the Bylaws mandate that in connection with the furnishing of electric energy, the Taxpayer's operations shall be so conducted that the Member(s) and other patrons will, through patronage, furnish capital for the Taxpayer. In order to induce patronage and to assure that the Taxpayer will operate on a non-profit basis, the Bylaw obligate the Taxpayer to account on a patronage basis to its Member(s) or other patrons for income received and receivable from the furnishing of electric energy in excess of (1) operating costs and expenses properly chargeable against the furnishing of electric energy, and (2) amount required to offset any losses incurred during its first year and any subsequent year thereafter. Amounts received from it Member(s) or other patrons in excess of operating costs and expenses at the moment of receipt by the Taxpayer are received with the understanding that they are furnished by the patrons as capital.

Under Article 8, Section 8.02(B) the Taxpayer is obligated to pay by credits to a capital account for its Member(s) and other patrons, amounts in excess of operating costs and expenses. The books and records of the Taxpayer shall be set up and kept in such a manner that at the end of each fiscal year the amount of capital, if any, so furnished by each Member and other patron is clearly reflected and credited in an appropriate record to the capital account of each Member and other patron.

Further that Article directs that the Taxpayer to within eight and one-half (8½) months after the close of the fiscal year, notify each Member and other patrons in writing of the amount of patronage capital so credited to its account. All such amounts credited to the capital account of any Member(s) and patrons shall have the same status as though they had been paid to the Member or patron pursuant to a legal obligation to do so and the Member or patron had then furnished corresponding amounts for capital.

Article 8.03(A) states that in the event of dissolution or liquidation of the Taxpayer, after all outstanding indebtedness of the Taxpayer shall have been paid, outstanding capital credits shall be retired without priority on a pro rata basis before any payment(s) are made on account of property rights of the Member(s).

Article 8.03(B) states that if, at any time prior to dissolution or liquidation, the Board of Directors shall determine that the financial condition of the Taxpayer will not be impaired thereby, the capital then credited to the Member(s) and other patrons' accounts may be retired in full or in part. Any such retirement of capital shall be as determined by resolution of the Board of Directors. Termination of a Member's membership shall not accelerate the payment of capital credits.

Coop and the Taxpayer represent that they serve "rural areas" for purposes of Revenue Act of 1962 (Pub. L. No. 87-834 (H.R. 10650)).

The Taxpayer requests the following rulings:

1. The Taxpayer is a not-for-profit electric organization operating on a cooperative basis.
2. Coop is a member of the Taxpayer.
3. The Taxpayer's patronage allocations to its members and other patrons in accordance with its Bylaws will qualify for exclusion from income as patronage dividends of an electric cooperative governed by the laws that preceded the enactment of subchapter T of the Code as part of the Revenue Act of 1962

While the requirements of subchapter C of the Code regarding corporate distributions and adjustments and other provisions are generally applicable to nonexempt cooperatives, these entities are distinguished from other types of corporations by a specific body of tax law. The scheme of taxation for nonexempt cooperatives was developed from the administrative pronouncements of the Service and decision of the judiciary over a fifty year period. These rules for tax treatment of most nonexempt cooperatives and their patrons were finally codified with the enactment

subchapter T of the Code as part of the Revenue Act of 1962. Pub. L. No. 87-834 (H.R. 10650).

With passage of subchapter T, the rules for deduction of patronage dividends and the treatment of patronage dividends in the hands of a cooperative's patrons were defined. However, section 1381(a)(2)(C) of the Code states that subchapter T is not applicable to organizations engaged in furnishing electric energy, or providing telephone service to persons in rural areas.

According to the Senate Finance Committee Report accompanying the 1962 Act, the intent of Congress was that nonexempt rural electric and telephone cooperatives would continue to be treated as under "present law."

In its report accompanying the legislation, the Senate Finance Committee described "present Law" as follows:

"Under present law patronage dividends paid by taxable cooperatives result in a reduction in the cooperative's taxable income only if they are paid during the taxable year in which the patronage occurred or within the period in the next year elapsing before the prior year's income tax return is required to be filed (including any extensions of time granted)." S. Rep. No. 1881, 87th Cong., 1st Sess. 113 (1962).

Under this earlier body of tax law applicable to nonexempt electric cooperatives, a cooperative may reduce its taxable income by any qualifying patronage dividends paid to their members/patrons. Further, under pre-1962 cooperative rules, the term "paid" means paid in cash or paid by notice of allocation. See also Rev. Rul. 83-135, 1983-2 C.B. 149 (a taxable cooperative not subject to the provisions of subchapter T of the Code may exclude from gross income the patronage dividends paid or allocated to its patrons in accordance with its by-laws).

While the phrase "operating on a cooperative basis" is not defined in the Code, Treasury Regulations, or the legislative history accompanying subchapter T, there are certain fundamental cooperative principles to which a corporation must adhere in order to operate on a cooperative basis.

In *Puget Sound Plywood, Inc. v. Commissioner*, 44 T.C. 305 (1965), *acq.* 1966-1 C.B. 3, three principles are described as fundamental to cooperative operation: (1) subordination of capital; (2) democratic control by the members; and (3) operation at cost, the vesting in and allocation among the members of all fruits and increases arising from their cooperative endeavor. Each of these three principles is addressed below.

Subordination of capital requires that control of the cooperative and ownership of the pecuniary benefits arising from the cooperative's business remain in the hands of the members/patrons of the cooperative rather than with nonpatron equity investors in the cooperative. The purpose of this limitation is to insure that the gains that accrue to the cooperative from the business that it transacts with its patrons will largely or completely inure to the benefit of those patrons rather than to its stockholders. To be operating on a cooperative basis, a cooperative must limit the financial return with respect to its equity capital. See *Puget Sound Plywood*, 44 T.C. at 308. Stated differently, a cooperative may not be operated for the purpose of paying a return on equity investments.

Democratic control of the cooperative, as envisioned in *Puget Sound Plywood*, 44 T.C. at 308, is typically achieved by voting on a one-member, one-vote basis. The principle of democratic control was further discussed in *Etter Grain Co. v. United States*, 462 F.2d 259 (5th Cir. 1972), in which the court noted that section 521, regarding exempt cooperatives, contemplates that the stock will be owned by the patrons of the cooperative. That section, "envision[s] the exempt association organized according to a model of a widely-based participatory democracy in which all the members are able to exercise a franchise of equal strength." Each member must have a single vote regardless of the size of its investment or the amount of business it does with the corporation.

The issue of democratic control is a question of fact. Rev. Rul. 58-616, 1958-2 C.B. 928, considered the democratic ownership and control concept as it applies to mutual insurance companies. The ruling states that whether democratic control is in the policyholders of a mutual insurance company depends on the circumstances of each case and is determined by the control which the policy holders actually exercise, to the exclusion of any group other than policyholders, and not upon the unexercised power to control which such other group has by statute or otherwise.

The requirement of operation at cost is met if the cooperative's net earnings or savings are distributed to the cooperative's patrons in proportion to the amount of business conducted with them. This requirement relates to:

"the proportionate vesting in and allocation among the worker-members of all fruits and increases from their cooperative endeavor, is achieved through statutes, bylaws, and contractual arrangements between the association and its members, whereby the elected officers of the association are required to make periodic allocations of the same among the members in proportion to their active participation as workers." *Puget Sound Plywood*, 44 T.C. at 308.

Rev. Rul. 70-481, 1970-2 C.B. 170, held that a corporation supplying services to its members at cost and making distributions to each member based on the value of business done with each member was "operating on a cooperative basis" within the meaning of section 1381(a)(2) of the Code.

A true patronage dividend that may be excluded from the income of a rural electric cooperative must meet the three tests set forth in *Farmers Cooperative Co. v. Birmingham*, 86 F. Supp 201 (N.D. Ia. 1949), and *Pomeroy Cooperative Grain Co. v. Commissioner*, 31 T.C. 674 (1958), *acq.*, AOD 1959-2 C.B. 6. Those tests are:

1. It must be made subject to a preexisting legal obligation;
2. The allocation must be made on the basis of patronage; and
3. The margins allocated must be derived from the profits generated from patrons' dealings with the cooperative.

Although the Code does not provide specific guidance as to what constitutes patronage-sourced income for a nonexempt electric cooperative, regulations and rulings address the issues for cooperatives governed by subchapter T of the Code. While not directly applicable to taxable utility cooperatives per se, arguably they reflect the correct analysis with respect patronage income of cooperatives subject to pre-1962 law.

The Senate Committee Report accompanying the cooperative provisions in the Revenue Act of 1951 indicated that the Congress intended to tax "ordinary" (i.e., non-farmer) cooperatives for:

"non-operating income...not derived from patronage, as for example in the case of interest or rental income, even if distributed to patrons on a pro rata basis." S. Rep. No. 781, 82d Cong. 1st Sess. (1951).

Section 1388(a)(3) of the Code specifies that a patronage dividend must be "determined by reference to the net earnings of the organization from business done with or for its patrons." That section further provides that the term "patronage dividend" does not include any amount paid to a patron to the extent that such amount is out earnings other than from business done with or for patrons. Further, it does not include earnings from business done with or for other customers "to whom no amounts are paid, or to whom smaller amounts are paid with respect to substantially identical transactions."

In Rev. Rul. 69-576, 1969-2 C.B. 166, a nonexempt farmers' cooperative borrowed money from a bank for cooperatives (itself a cooperative) to finance the acquisition of agricultural supplies for resale to its members. The bank for cooperatives

allocated and paid interest from its net earnings to the nonexempt farmers' cooperative which it in turn allocated to its members.

In determining whether the allocation was from patronage sources, the ruling states:

The classification of an item of income as from either patronage or nonpatronage sources is dependent on the relationship of the activity generating the income to the marketing, purchasing, or service activities of the cooperative. If the income is produced by a transaction which actually facilitates the accomplishment of the cooperative's marketing, purchasing, or service activities, the income is from patronage sources. However, if the transaction producing the income does not actually facilitate the accomplishment of these activities but merely enhances the overall profitability of the cooperative, being merely incidental to the association's cooperative operation, the income is from nonpatronage sources. Rev. Rul. 69-576 at 167.

The ruling concluded that in as much as the income received by the nonexempt cooperative from the bank for cooperatives resulted from a transaction that financed the acquisition of agricultural supplies which were sold to its members, thereby directly facilitating the accomplishment of the cooperative's marketing, purchasing, or service activities, the income was patronage sourced.

In *Puget Sound Plywood*, the three principles fundamental to cooperative operation were described as subordination of capital, democratic control by the members, and operation at cost, the vesting in and allocation among the members of all fruits and increases arising from their cooperative endeavor.

The Taxpayer's Bylaws satisfy those prerequisites. Article 1, Section 1.03(A) of the Taxpayer's Bylaws, states that any Member shall be a distribution electric cooperative that purchases electric capacity and/or energy, or other products and/or services from the Taxpayer. Article 2, Section 2.01 states that a member shall have no individual or separate interest in the property or assets of the Taxpayer except, upon dissolution, after (1) all debts and liabilities of the Taxpayer shall have been paid, and (2) all capital furnished through patronage shall have been returned. Any remaining property and assets of the Taxpayer shall be distributed to its Member or Members based on the historic patronage of each.

Article 3, Section 3.05 specifies that Member(s) shall be entitled to only one (1) vote upon each matter submitted to a vote. Article 8, Section 8.01 directs that the Taxpayer shall be at all times operated on a cooperative non-profit basis for the mutual

benefit of its Member(s) or other patrons and forbids any interest or dividends to be paid or payable on any capital furnished by its Member(s) or other patrons.

Article 8, Section 8.02(A) of the Bylaws dictates that the Taxpayer to account on a patronage basis to its Member(s) or other patrons for income received and receivable from the furnishing of electric energy in excess of (1) operating costs and expenses properly chargeable against the furnishing of electric energy, and (2) amount required to offset any losses incurred during its first year and any subsequent year thereafter.

Under Article 8, Section 8.02(B) the Taxpayer is obligated to pay by credits to a capital account for its Member(s) and other patrons, amounts in excess of operating costs and expenses. Additionally, that Section directs that the Taxpayer to within eight and one-half (8½) months after the close of the fiscal year, notify each Member and other patrons in writing of the amount of patronage capital so credited to its account.

Article VIII of the Taxpayer's Articles of Incorporation states that the cooperative will be formed without any purpose of pecuniary profit to itself and declares it shall have no capital stock. Further, it declares that the initial membership of the cooperative shall be constituted of the charter member Coop as represented by Coop's Board of Directors. By incorporation documents filed with State A, Coop is a member of the Taxpayer.

As has been discussed previously, qualifying "true patronage dividends" historically was an exclusion from cooperative income. The Senate Committee Report accompanying the cooperative provisions in the Revenue Act of 1951 indicated that the Congress intended to tax "ordinary" (i.e., non-farmer) cooperatives for: "non-operating income...not derived from patronage, as for example in the case of interest or rental income, even if distributed to patrons on a pro rata basis."

With passage of subchapter T, the rules for deduction of patronage dividends and the treatment of patronage dividends in the hands of a cooperative's patrons were defined. However, section 1381(a)(2)(C) of the Code states that subchapter T is not applicable to organizations engaged in furnishing electric energy, or providing telephone service to persons in rural areas.

According to the Senate Finance Committee Report accompanying the 1962 Act, the intent of Congress was that nonexempt rural electric and telephone cooperatives would continue to be treated as under "present law." S. Rep. No. 1881, 87th Cong., 1st Sess. 113 (1962).

In the Taxpayer's Bylaws Article 8, Section 8.02(A) obligates the Taxpayer to account on a patronage basis to its Member(s) or other patrons for income received and receivable from the furnishing of electric energy in excess of cost. It also establishes a

pre-existing obligation that all amounts received from its Member(s) or other patrons in excess of operating costs and expenses at the moment of receipt by the Taxpayer are received with the understanding that they are furnished by the patrons as capital. Further, the Taxpayer is obligated to pay by credits to a capital account for its Member(s) and other patrons, amounts in excess of operating costs and expenses, and that Article directs that Taxpayer to within eight and one-half (8½) months after the close of the fiscal year, notify each Member and other patrons in writing of the amount of patronage capital so credited to its account. Further, the Taxpayer has made the representation that the Taxpayer is electric cooperative serving persons in rural areas.

Accordingly, based solely on the forgoing we rule that:

1. The Taxpayer is a not-for-profit electric organization operating on a cooperative basis.
2. Coop is a member of the Taxpayer.
3. The Taxpayer's patronage allocations to its members and other patrons in accordance with its Bylaws will qualify for exclusion from income as patronage dividends of an electric cooperative governed by the laws that preceded the enactment of subchapter T of the Code as part of the Revenue Act of 1962.

This ruling is directed only to the taxpayer that requested it. Under section 6110(k)(3) of the Code it may not be used or cited as precedent. In accordance with a power of attorney filed with the request, a copy of the ruling is being sent to your authorized representative

Sincerely yours,

Paul F. Handleman

Paul F. Handleman
Chief, Branch 5
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

cc: